

STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
45 Fremont Street, 21st Floor
San Francisco, California 94105

**Section 2361. CONSIDERATION OF LOSSES AND LOSS EXPOSURE IN
RESIDENTIAL PROPERTY INSURANCE RATING AND UNDERWRITING**

INITIAL STATEMENT OF REASONS

File No. RH04041245

Date: October 28, 2004

California Insurance Commissioner John Garamendi will hold a public hearing to consider regulations governing the rates, rating plans, rating systems and underwriting rules of California residential property (homeowners) insurers, specifically considering the adoption of Title 10, California Code of Regulations, Chapter 5, Subchapter 3, Article 7.2, Section 2361. The proposed regulation is entitled: *Consideration of Losses and Loss Exposure in Residential Property Insurance Rating and Underwriting*.

STATEMENT OF SPECIFIC PURPOSE

In *State Farm Mutual Automobile Insurance Company v. Garamendi* (32 Cal. 4th 1029; 88 P.3d 71; 12 Cal. Rptr. 3d 343; 2004) the California Supreme Court made clear, once again, that the Commissioner's authority under Proposition 103 is extremely broad. The court went on to note that the stated purpose of Proposition 103 is "to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." (Historical and Statutory Notes, 42A West's Ann. Ins. Code (1993 ed.) foll. § 1861.01, p. 649.)" The Supreme Court also made it clear that Proposition 103 is "not only about rates and rate regulation; it also concerns other factors that may impermissibly affect the availability of insurance." The subject of this hearing is a regulation that is designed and intended to protect California Insurance consumers and to ensure that residential property insurance is "fair, available and affordable for all Californians."

Protecting Consumers From Arbitrary Rates

Arbitrary underwriting factors are not actuarially sound and lead to arbitrary and impermissible insurance rates. Arbitrary underwriting factors result in rates that are excessive, inadequate or unfairly discriminatory, in contravention of Proposition 103. Where factors used to price an insurance product are not related to the future costs associated with the risk, the factor is arbitrary, producing an arbitrary rate that is actuarially unsound. The proposed regulation requires underwriting rules and guidelines have a "substantial relationship to loss exposure" to ensure that the resultant rates are actuarially sound and not arbitrary. While this regulation does not proscribe specific rates, rating plans, rating systems and underwriting rules, it does require that the rating plans, rating systems and underwriting rules have a discernable relationship to risk of loss. This regulation also requires that insurers take reasonable steps to assure the accuracy of data used in underwriting. These requirements are designed to assure that the rates

calculated by application of factors in rating plans, rating systems and underwriting rules, are actuarially sound.

Availability

Problems associated with the lack of availability of homeowners insurance and the persistent erosion of the homeowners insurance market continue to plague California insurance consumers. Arbitrary rating and underwriting factors have been shown to have a significant impact on homeowners insurance availability in California. The use of arbitrary underwriting criteria and reliance on flawed claims history data are the source of a critical constriction in the California residential property insurance market. This regulation addresses arbitrary and unsound factors used in rating plans, rating systems and underwriting and the use of inaccurate claims history data. The Commissioner believes that unsound underwriting and rating and directly impacts the availability of residential property insurance in California.

Affordability

The use of arbitrary underwriting criteria and reliance on flawed claims history data has a direct impact on rates paid by California insurance consumers. Consumers locked out of the insurance market due to unsound underwriting and eligibility criteria are often forced into residual insurance markets which charge rates markedly higher than standard markets. The surcharging of rates based on faulty claims history databases result in excessive and actuarially unsound rate increases. Unsound underwriting directly skews loss projections which are integral to the setting of base rates. This regulation addresses arbitrary and unsound factors used in rating plans, rating systems and underwriting and the use of inaccurate claims history data. The Commissioner believes that unsound underwriting and rating and the use of inaccurate claims history data directly impacts the affordability of residential property insurance in California.

Unfair Discrimination

Arbitrary rates, rating plans, rating systems and underwriting rules have been shown to result in unfair discrimination in the California homeowners insurance market. California insurance consumers are being unfairly denied access to affordable homeowners insurance due to unfairly discriminatory underwriting and rating practices and the use of inaccurate claims history data. Arbitrary rating plans, rating systems and underwriting rules also produce unfairly discriminatory rates. This regulation addresses arbitrary and unsound factors used in rating plans, rating systems and underwriting as well as the use of inaccurate claims history data which result in unfair discrimination rates and availability in the California residential property insurance market. The Commissioner believes unfair discrimination results from the use of unsound insurance underwriting and rating and inaccurate claims history data.

Excessive And Inadequate Rates

The application of arbitrary rates, rating plans, rating systems and underwriting rules, such as those that have no discernable connection to the future risk of loss, directly impact the actual losses and loss projections that are integral to the calculation of rating factors which have a direct and immediate impact on premium rates for policies of homeowners insurance. The use of

arbitrary rating and underwriting factors and inaccurate claims history data therefore results in rates that may be excessive, inadequate or unfairly discriminatory.

Accuracy

The proposed regulation addresses the accuracy of information used in by insurers in underwriting and rating policies of homeowners insurance. Unreasonable reliance on data collected by insurance-support organizations has been shown to have a significant impact on homeowners insurance availability in California. Unreasonable reliance on data collected by insurance-support organizations has also been shown to have a significant impact on premiums paid for homeowners insurance in California. The proposed regulation addresses the need for insurers to take reasonable measures to verify the accuracy of data used in underwriting and rating policies of homeowners insurance in California. Inaccurate data used in rating plans, rating systems and underwriting rules result in unsound rates and unfair market constriction in the California residential property insurance market.

Proposed Regulation by Subsection

The following are statements of specific purpose and effect of each subsection of the proposed regulation including the rationale for the determination that each subdivision is reasonably necessary to carry out the purpose for which it is proposed. The subject matter of the proposed regulation is consideration of losses and loss exposure in residential property insurance rating and underwriting. The proposed regulation is designed to address residential property insurance availability and unfairly discriminatory underwriting and rating in California.

A convergence of forces and unforeseen circumstances has come together in California to create a crisis in the residential property insurance market. While there are laws specific to insurance rating and underwriting that address cancellation, nonrenewal and eligibility for homeowners insurance, both the insurance industry and the insurance consuming public are unclear as to the exact application of these laws. This regulation is necessary to define, clarify and make specific the application of these laws in California.

By defining certain terms and providing concrete examples the proposed regulation is necessary to clear up any ambiguity in this area of the insurance law.

Proposed California Code of Regulations section 2361(a) - Adopt

The proposed subsection states that proposed California Code of Regulations (CCR) section 2361, subsections (a) through (f) apply to residential property risks subject to California Insurance Code (CIC) section 675. The purpose of this subsection is to define the scope and applicability of proposed CCR §2361.

Proposed California Code of Regulations section 2361(b) - Adopt

This proposed subsection sets forth definitions for the terms used substantively in the section. The purpose of this proposed subsection is to set forth the scope and applicability of the proposed section by providing that the definitions apply when an insurer considers losses or loss

exposure in residential property insurance rating and underwriting. This proposed subsection is necessary to identify the definitions as used substantively in the text of the proposed regulation.

Proposed California Code of Regulations section 2361(b)(1) - Adopt

This proposed subsection defines the term “substantial relationship to loss exposure” by providing that a substantial relationship to the loss exposure exists when a hazard, physical condition, or liability exposure creates a material and identifiable effect on the likelihood of a covered loss. The purpose of this proposed subsection is to provide a consistent definition of the term “substantial relationship to loss exposure.”

The Commissioner believes that the term “substantial relationship to risk of loss exposure” has been the cause of some confusion for the insurance industry. This confusion is in part the source of a lack of availability in the homeowners insurance market. The stated purpose of Proposition 103 "is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." The Commissioner is charged with enforcing Proposition 103 and all other Insurance Code provisions. Proposing this definition, and the other definitions contained herein, is necessary to ensure homeowners insurance remains available in California.

This proposed subsection is necessary to define the term “substantial relationship to risk of loss exposure” in a clear and concise manner to better facilitate insurance industry understanding of the meaning of the term in the proposed context. Where the term is substantively applied the intent is to make specific the meaning of the term and its relationship to other applicable and relevant insurance laws.

Proposed California Code of Regulations section 2361(b)(2) - Adopt

This proposed subsection defines the term “increased risk of loss” by providing that an increased risk of loss will exist when a property or liability hazard or physical condition is identified or discovered which both bears a substantial relationship to the loss exposure and presents a greater likelihood of future loss than if the hazard or condition did not exist. The purpose of this proposed subsection is to provide a consistent definition of the term “increased risk of loss”

The Commissioner believes that the term “increased risk of loss” has been the cause of some confusion for the insurance industry. This confusion is in part the source of a lack of availability in the homeowners insurance market. The stated purpose of Proposition 103 "is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." The Commissioner is charged with enforcing Proposition 103 and all other Insurance Code provisions. Proposing this definition, and the other definitions contained herein, is necessary to ensure homeowners insurance remains available in California.

This proposed subsection is necessary to define the term “increased risk of loss” in a clear and concise manner to better facilitate insurance industry understanding of the meaning of the term in the proposed context. Where the term is substantively applied the intent is to make specific the meaning of the term and its relationship to other applicable and relevant insurance laws.

Proposed California Code of Regulations section 2361(b)(3) - Adopt

This proposed subsection provides a definition for “fully remedied or otherwise resolved.” The purpose of this proposed subsection is to set forth definitions for the terms used substantively in the section. The subsection sets forth the scope and applicability of the proposed section by providing that the definitions apply when an insurer considers losses or loss exposure in residential property insurance rating and underwriting.

This proposed subsection specifically defines the term “fully remedied or otherwise resolved” and is necessary to make clear the meaning of the term as used substantively later in the regulation.

Proposed California Code of Regulations section 2361(b)(3)(i) - Adopt

This proposed subsection provides that a fully remedied or otherwise resolved loss or loss exposure exists when the property has been returned to a state of repair that is equal or superior to the condition existing prior to the occurrence or condition which created the increased risk of loss.

The Commissioner believes that the term “fully remedied or otherwise resolved” needs to be defined in order to avoid confusion that may impact availability in the homeowners insurance market. The stated purpose of Proposition 103 "is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." The Commissioner is charged with enforcing Proposition 103 and all other CIC provisions. Proposing this definition, and the other definitions contained herein, is necessary to ensure homeowners insurance remains available in California.

The purpose of this proposed subsection is to define the term in a clear and concise manner and is necessary to better facilitate insurance industry understanding of the meaning of the term in the proposed context. Where the term is substantively applied the intent is to make specific the meaning of the term and its relationship to other applicable and relevant insurance laws.

Proposed California Code of Regulations section 2361(b)(3)(ii) - Adopt

This proposed subsection provides that a fully remedied or otherwise resolved loss or loss exposure exists when the liability hazard insured against has been reduced to equal or below the level existing prior to the loss or loss exposure.

The Commissioner believes that the term “fully remedied or otherwise resolved” needs to be defined in order to avoid confusion that may impact availability in the homeowners insurance

market. The stated purpose of Proposition 103 "is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." The Commissioner is charged with enforcing Proposition 103 and all other CIC provisions. Proposing this definition, and the other definitions contained herein, is necessary to ensure homeowners insurance remains available in California.

The purpose of this proposed subsection is to define the term in a clear and concise manner and is necessary to better facilitate insurance industry understanding of the meaning of the term in the proposed context. Where the term is substantively applied the intent is to make specific the meaning of the term and its relationship to other applicable and relevant insurance laws.

Proposed California Code of Regulations section 2361(b)(3)(iii) - Adopt

This proposed subsection provides that a fully remedied or otherwise resolved loss or loss exposure exists when the increased risk of loss has been entirely eliminated because the property is no longer owned by the insured, the liability hazard is no longer the responsibility of the insured, the policy no longer provides coverage for that exposure, or the condition that caused the increased risk of loss has been removed.

The Commissioner believes that the term "fully remedied or otherwise resolved" needs to be defined in order to avoid confusion that may impact availability in the homeowners insurance market. The stated purpose of Proposition 103 "is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." The Commissioner is charged with enforcing Proposition 103 and all other CIC provisions. Proposing this definition, and the other definitions contained herein, is necessary to ensure homeowners insurance remains available in California.

The purpose of this proposed subsection is to define the term in a clear and concise manner and is necessary to better facilitate insurance industry understanding of the meaning of the term in the proposed context. Where the term is substantively applied the intent is to make specific the meaning of the term and its relationship to other applicable and relevant insurance laws.

Proposed California Code of Regulations section 2361(b)(4) - Adopt

This proposed subsection defines the term "adverse underwriting decision" by referring to California Insurance Code Section 791.02. The purpose of this proposed subsection is to provide a consistent definition for "adverse underwriting decision."

This proposed subsection with the definition and reference is necessary to ensure the entities to which this regulation will apply have a clear and concise understanding of the use and application of the term.

Proposed California Code of Regulations section 2361(c) - Adopt

This proposed subsection provides that where an adverse underwriting decision is based on losses or loss exposure, when otherwise allowed by law, the adverse underwriting decision shall be based upon conditions of the individual risk which bear a substantial relationship to the loss exposure and which present an increased risk of loss when compared to other risks eligible for coverage under the insurer's underwriting guidelines.

This proposed subsection also provides that an insurer shall not base, in whole or in part, an adverse underwriting decision on losses or loss exposures that have been fully remedied or otherwise resolved. The proposed subsection provides that losses or loss exposures that have been fully remedied or otherwise resolved are no longer substantially related to the risk of loss.

This proposed subsection is necessary in order to make clear the application of this section, and to also make clear how the various defined terms interact. The purpose of this proposed subsection is to promote proper underwriting in the homeowners lines of insurance. This proposed subsection is also necessary in order to avoid confusion that may impact availability in the homeowners insurance market. The stated purpose of Proposition 103 "is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." The Commissioner is charged with enforcing Proposition 103 and all other CIC provisions. Proposing this definition, and the other definitions contained herein, is necessary to ensure homeowners insurance remains available in California.

The purpose of this proposed subsection is to make clear that there can be no justification for basing an adverse underwriting decision on losses or loss exposures which no longer exist because they bear no relations to the risk of loss.

This proposed subsection is necessary to make application of the section clear and concise to better facilitate insurance industry understanding of the meaning of the term.

Proposed California Code of Regulations section 2361(d) - Adopt

This proposed subsection provides that an insurer shall not base an adverse underwriting decision, in whole or in part, on an inquiry regarding coverage, unless a hazard or condition is identified which both bears a substantial relationship to the loss exposure and presents an increased risk of loss.

The purpose of this proposed subsection is to make clear that mere inquiries cannot be used to form the basis of an adverse underwriting decision because inquiries bear no relationship to the future risk of loss. An inquiry about mold coverage does not cause the house to get toxic mold.

This proposed subsection is necessary to make clear the application of this section, and to also make clear how the various defined terms interact. This proposed subsection is necessary to promote proper underwriting in the homeowners lines of insurance. This proposed subsection is also necessary in order to avoid confusion that may impact availability in the homeowners insurance market. The stated purpose of Proposition 103 "is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." The Commissioner is charged with enforcing Proposition 103 and all other CIC provisions. Proposing this definition, and the other definitions contained herein, is necessary to ensure homeowners insurance remains available in California.

This proposed subsection is necessary to make application of the section clear and concise to better facilitate insurance industry understanding of the meaning of the term.

Proposed California Code of Regulations section 2361(e) - Adopt

This proposed subsection provides that that an insurer shall gather adequate information to determine that an increased risk of loss exists before a loss, loss exposure, or an inquiry with respect to coverage can be used as grounds for an adverse underwriting decision. The proposed subsection adds that in accordance with California Insurance Code Section 791.12, an insurer cannot rely solely on information obtained from an insurance-support organization. The proposed section also provides that if the information is from an insurance support-organization, the insurer shall obtain further relevant information in addition to the material obtained from the insurance-support organization. Sources for this information may include the insurance application or supplemental application, telephone inquiry, written inquiry, and physical inspection.

The purpose of this proposed subsection is to make clear that an adverse underwriting decision must be based on exposure to loss, therefore an insurer must gather sufficient information to make a reasonable determination about what the actual loss exposure is before using that loss exposure to rate the policy.

This subsection is necessary in order to make clear the application of this section, and to also make clear how the various defined terms interact. This section is necessary to promote proper underwriting in the homeowners lines of insurance. This section is also necessary in order to avoid confusion that may impact availability in the homeowners insurance market. The stated purpose of Proposition 103 "is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." The Commissioner is charged with enforcing Proposition 103 and all other CIC provisions. Proposing this definition, and the other definitions contained herein, is necessary to ensure homeowners insurance remains available in California.

This proposed subsection is designed to make application of the section clear and concise to better facilitate insurance industry understanding of the meaning of the term.

Proposed California Code of Regulations section 2361(f) - Adopt

This proposed subsection provides that when an insurer makes an adverse underwriting decision, the insurer shall maintain documentation detailing the hazards or physical conditions which created an increased risk of loss and how this information was considered in policy rating or underwriting. The proposed subsection adds that this documentation shall be maintained during the time in which the policy is in force and otherwise as required by law.

This proposed subsection is necessary to make clear the application of this section, and to also make clear how the various defined terms interact. The purpose of this proposed subsection is necessary to promote proper underwriting in the homeowners lines of insurance. This proposed subsection is also necessary to enable CDI to verify compliance with the insurance laws.

This proposed subsection is necessary to make application of the section clear and concise to better facilitate insurance industry understanding of the meaning of the term.

This regulation does not purport, nor is it intended, to do the following: place any new constraint on insurer use of loss history or credit related databases or require insurers to offer policies of insurance on risks they would not, following company underwriting and eligibility guidelines, ordinarily insure.

IDENTIFICATION OF STUDIES AND REPORTS

The following is a list of media reports reviewed by CDI personnel during the drafting phase of this regulation.

1. Max, Sarah. *The Great Insurance Crisis*. CNN Money, January 14, 2003.
1. McAllister, Sue. *Finding Property Insurance Becomes More Challenging*. San Jose Mercury News, December 2, 2002.
2. O'Reilly, Kevin. *Hard Market Hits California Homeowners*. Insurance Journal, April 7, 2003.
3. Benda, David. *Static Over Statistics*. Record Searchlight, June 01, 2003.
4. McSwain, Dan. *State Action Planned in Insurance Crisis*. North County Times, February 01, 2003.
5. Harney, Kenneth. *Risky Business – Calling Your Insurance Agent*, San Francisco Chronicle. April 27, 2003.
6. Lloyd, Carol. *Homeowner's Insurance Springs a Leak Water Damage Claims Causing a Flood of Cancelled Coverage*. SF Gate, February 18, 2003.
7. Editorial. *Access To Insurance and Soaring Premiums Are Barriers To Homeownership, Says NAR President*. Real Estate News, July 07, 2003.
8. Unknown. *Insurance Commissioner Defends Crackdown*. Sacramento Business Journal, June 06, 2003.
9. Sandra Hughes. *Insurance Industry Blacklist*. CBSNews.com, January 2, 2003

CDI also relied on 2000 OAL Determination No. 15 dated October 24, 2000, in drafting this regulation.

CDI did not rely upon any technical, theoretical and/or empirical study, report or similar document in proposing this regulation. However, since this regulation was drafted several studies, reports and numerous media accounts have been released which may support the Commissioner's contentions as contained in this notice. To the extent that those reports are relied upon for support during the rulemaking process, those reports, studies and media accounts will become part of the rulemaking file and therefore public records relevant to this rulemaking.

SPECIFIC TECHNOLOGIES OR EQUIPMENT

Adoption of the proposed regulation would not mandate the use of specific technologies or equipment.

CONSIDERATION OF ALTERNATIVES

Performance standards were considered. The objective identified was fairness in residential property underwriting. However, one of the reasons performance standards were rejected was that the criteria by which the attainment of this objective was to be evaluated would necessarily be impracticable, vague or otherwise ineffective given the abstract nature of the objective.

Performance standards were considered and rejected because it was decided that compliance with performance standards would be much more costly than compliance with prescriptive standards in the context of residential property underwriting. Prescriptive standards are more efficient in this context because, unlike performance standards, they provide the affected businesses a means of determining with certainty and exactitude whether or not they are in compliance, and if they are not, how to achieve compliance. Additionally it was felt that performance standards would foster costly litigation.

IMPACT ON SMALL BUSINESS

The Commissioner has determined that the proposed regulations do not affect small businesses.

Date: October 28, 2004

JOHN GARAMENDI
Insurance Commissioner

By: _____
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